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SPECIAL COMMITTEE ON MERGERS, ACQUISITIONS
AND CORPORATE CONTROL CONTESTS

May 3, 2006

Via email: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Attention: Nancy M. Morris, Secretary

File No: Proposed NASD Rule 2290 Regarding Fairness Opinions
SR-NASD-2005-080; Release No. 34-53598 (the "Release")

Ladies and Gentlemen:

This letter is submitted on behalf of the Special Committee on Mergers, Acquisitions and Corporate Control Contests of the Association of the Bar of the City of New York (the "Committee") in response to the request by the Securities and Exchange Commission (the "Commission") for comments on the proposed rule change filed by the National Association of Securities Dealers, Inc. ("NASD") on June 24, 2005, as amended by filings with the Commission dated November 30, 2005, January 25, 2006 and March 1, 2006 (as so amended, "Proposed Rule 2290"). The Committee is composed of members whose practices focus on mergers and acquisition transactions and related corporate law, corporate governance, executive compensation and securities regulation matters. The Committee includes lawyers in private practice as well as from corporate and investment bank law departments and academia.

INTRODUCTION

As the Commission is aware, in January and February 2005, the Committee and nineteen other interested persons responded to NASD's Notice to Members 04-83, which requested comments on whether NASD should propose a new rule that would address conflicts of interest when NASD member firms provide fairness opinions in corporate control transactions. That comment process has resulted in the currently proposed new NASD rule.

As noted in the Committee's comment letter to NASD, dated February 1, 2005 (the "Initial Letter"), the Committee supported many of the elements of the possible new rule suggested by NASD. We were pleased to see that many of the Committee's suggestions to refine or otherwise clarify the new rule are reflected in Proposed Rule 2290. As a consequence,

our concerns and comments are substantially more limited, and the Committee is, with one significant exception, supportive of Proposed Rule 2290 as currently contemplated.

The Committee very much appreciates this opportunity to provide comments on Proposed Rule 2290. In addition to setting forth one substantive modification, we make a small number of technical suggestions to further refine and clarify Proposed Rule 2290and respond to certain questions posed by NASD and the Commission in the Release.

COMMENT ON PROPOSED RULE 2290(b)(3)

The Committee continues to believe strongly that Proposed Rule 2290(b)(3) is both inconsistent with the approach taken in the remainder of the proposed rule to address the concerns giving rise to Proposed Rule 2290 and ill advised. If adopted, Proposed Rule 2290(b)(3) would require that:

> (b) any member issuing a fairness opinion must have procedures that address the process by which a fairness opinion is approved by a firm, including: . . . (3) the process to evaluate whether the amount and nature of the compensation from the transaction underlying the fairness opinion benefiting any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.

Proposed Rule 2290(b)(3), like the other subsections of Proposed Rule 2290(b), on its face takes the form of a requirement that each NASD member develop and implement certain procedures in connection with rendering fairness opinions. As noted in our Initial Letter, we believe that this generally is the correct approach to achieving NASD's goals.

There is a striking difference, however, between the other subsections of Proposed Rule 2290(b) and Proposed Rule 2290(b)(3). The other subsections mandate the development of procedures addressing the types of transactions in which members will use a fairness committee, the process for selecting a committee's members, the necessary qualifications of committee members, the process to promote a balanced review by the committee, and the process to determine whether the particular valuation analyses used are appropriate to a particular transaction. These requirements reflect an apparent policy judgment that the fairness opinion procedures developed and implemented by NASD members should be designed to achieve certain objectives – i.e., consistent standards for when fairness committees are used and how their members are selected, "qualified" committee members, "balanced" review by committees and "appropriate" valuation analyses – in order to, in NASD's words, "mitigate potential conflicts in rendering fairness opinions." In striving for these objectives, however, NASD appropriately does not mandate specific procedures that all NASD members must adopt and follow or substantive analyses that must be undertaken or even considered.

Proposed Rule 2290(b)(3) stands out as a stark exception to this approach. NASD goes to great length in the Release to declare that it is not purporting to judge whether or not differential payments should or should not be taken into consideration in arriving at any given fairness opinion.[1] Proposed Rule 2290(b)(3) nevertheless singles out this one possible element that may arise in a class of transactions that can present a broad variety of complex financial and analytical issues and insists that its relevance to the substantive financial analysis be addressed through internal procedures. Through this requirement Proposed Rule 2290(b)(3) effectively imposes on NASD members the responsibility of determining whether differential management compensation should ever be a factor for a financial advisor in making financial fairness determinations; and if so, in what transactions or circumstances; and, if so, how to define and memorialize the related process to be employed from transaction to transaction. In this regard, Proposed Rule 2290(b)(3) stands out as strangely inconsistent with the otherwise non-prescriptive approach reflected in the remainder of the rule.

Moreover, Proposed Rule 2290(b)(3) is uniquely prescriptive with regard to an element that appears wholly unrelated to the overarching goal that led to the initial proposal of the Proposed Rule – the disclosure and mitigation of real or perceived conflicts of interests between fairness opinion providers, on the one hand, and their clients (or other interested parties), on the other, that might skew the fairness opinion process.

The potential conflict arising from the differential compensation paid to management relative to shareholders has received a great deal of attention. We are sympathetic to NASD's apparent desire to address public concern over this potential conflict. However, the potential conflict of interest posed by differential compensation is between management, on the one hand, and its shareholders, on the other, and should not be confused with the entirely separate issue of real or perceived conflicts of interest between a fairness opinion provider and its client, the issue which we understand Proposed Rule 2290 was developed to address. We believe that it is inappropriate to mandate that broker-dealers rendering fairness opinions serve as "gatekeepers" to protect shareholders from a potential conflict that may arise with their management. State corporation law devolves on boards of directors both the power and responsibility in the exercise of their fiduciary duties to shareholders and their business judgment to manage potential allocative conflicts among shareholders, management and the other stakeholders of a company.[2] Bro-

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[1] "[Proposed Rule 2290(b)(3)] does not reach the implicit conclusion that such differential payments are a factor as to whether a transaction is fair, but in NASD's view, it would be equally wrong to conclude that such differential payments are inappropriately placed among the factors and indicia that one should consider in rendering a fairness opinion. . . . However, NASD also believes it is true that the considerations surrounding the issuance of a fairness opinion are artificially truncated when the total amount that a buyer is willing to pay and how such payment is allocated is never an appropriate factor in a change of control transaction." Section D.3 of the Release.

[2] The Committee notes that the Commission's recently proposed amendments to Rule 14d-10 recognize that approval of certain employment compensation, severance and other employee benefit arrangements by a compensation committee comprised of independent directors is sufficient to alleviate concerns that such arrangements constitute an inappropriate diversion of transaction consideration in connection with tender offers. If NASD and the Commission nevertheless determine generally to require the procedures contemplated by Proposed Rule 2290(b)(3), the Committee suggests that a similar "safe harbor" concept be considered to provide that such procedures would not be required where the differential benefits to be received

ker-dealers engaged to render a fairness opinion with respect to a transaction generally do not hold themselves out as possessing either the analytical foundation, the professional expertise or the experience with the company and its management to supplant or even review the determinations by the board of directors as to how to manage potential conflicts between stakeholders of the company.[3]

Neither the financial analytics commonly employed by financial advisors to render fairness opinions nor the professional expertise of financial advisors purports to provide financial advisors with the competence relevant to a judgment about the appropriateness of management compensation in the context of a change in control transaction.[4] Fairness opinion providers value companies, not the services of individual employees. These types of compensation determinations are made regularly by boards of directors and their compensation committees in the exercise of their fiduciary duties and business judgment – with the advice of compensation consultants, actuaries, employment lawyers and other compensation experts. The fact that an employment or compensation arrangement arises in the context of a change of control transaction does not alter the appropriate allocation of responsibility for such determinations.

We believe that Proposed Rule 2290(b)(3) implies, at the very least, that a member should, as part of its fairness opinion procedures either make its own independent substantive determination as to the appropriateness of the compensation to be paid to insiders relative to the consideration received by shareholders in a transaction or make a determination as to whether the board of directors of its client acted properly in balancing the interests of management and shareholders and, for the foregoing reasons, we believe that the inclusion of Proposed Rule 2290(b)(3) in Proposed Rule 2290 is inappropriate and should be reconsidered.

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had been approved by an appropriate group of independent directors or did not exceed a fixed de minimis amount.

[3] The Release notes that this point has been made by earlier commentators but does not, in our view, adequately address it.

[4] In evaluating a particular change in control transaction which also involves an element of compensation to a senior executive, a board of directors may consider, in the exercise of its fiduciary duties and business judgment, among other things, the reasonableness of the proposed compensation, the potential conflict that such compensation creates for the executive and whether the amount of the compensation should and could be reduced and the freed up dollars redeployed to increase the price paid to shareholders. In evaluating these issues, a board may discuss and seek information relating to various questions, including: How does the proposed compensation compare to the executive's current compensation? How does the proposed compensation compare to the compensation received by the executive's "peers" at other companies? Who exactly are the executive's "peers"? What companies are appropriate "peer" companies? What talents, skills and experience does the executive possess relative to her peers? What are the executive's health, age and retirement plans? Would the executive have entered into the employment agreement if it provided for a different mix or lower amount of compensation? Is the executive's recommendation that the board approve the transaction unduly influenced by the prospect of her own post-closing compensation? Would the buyer be willing to enter into the transaction and be willing to pay at least the same price to the shareholders if the executive had refused to enter into the employment agreement? Would the buyer be willing to increase the price paid to the shareholders if the executive's compensation was reduced?

COMMENTS ON QUESTIONS RAISED BY NASD AND THE COMMISSION

NASD QUESTION

Q.1 Whether to amend Proposed Rule 2290(a)(3) to include affiliates of companies involved in the transaction.

Proposed Rule 2290(a)(3) requires disclosure in fairness opinions as to whether any material relationship during the past two years has existed or is mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and the companies that are involved in the transaction that is the subject of the fairness opinion.

In the Release, it is noted that, unlike Item 1015 of Regulation M-A, Proposed Rule 2290(a)(3) does not require disclosure of material relationships with affiliates of such companies but that NASD intends to review the comment letters received by the Commission before determining whether to amend Proposed Rule 2290(a)(3) to include affiliates. For the reasons set forth below, the Committee does not believe that such an amendment is appropriate.

First, we note that Item 1015 of Regulation M-A does not require disclosure of material relationships between the member and any party to the transaction other than its issuer/client much less affiliates of any such other party. Second, NASD and the Commission should not underestimate the difficulty member firms may have in identifying and confirming the existence of material relationships with every affiliate of their issuer/clients, particularly large diverse issuer/clients, especially within the tight time frame in which fairness opinions are often prepared and provided, and in light of informational barriers between departments or affiliates that firms frequently erect precisely to avoid conflicts. It would be even more difficult to identify and check for material relationships with affiliates of the issuer/client's transaction counterparty, particularly when this information would not otherwise be required to be disclosed by Item 1015 of Regulation M-A. Third, the largely similar information (at least with respect to the member's issuer/client) required to be disclosed by Item 1015 of Regulation M-A in many disclosure documents filed with the Commission is likely to be more accurate precisely because both the member and its issuer/client have additional time between the date the fairness opinion is rendered and the date the disclosure document is filed with the Commission to gather and verify such information. The Committee is concerned that requiring such disclosure in the fairness opinion itself may result in rushed, inaccurate disclosure that varies from the information disclosed in disclosure documents filed with the Commission through no fault of the member or its issuer/client. If, nevertheless, NASD and the Commission determine to require such disclosure in fairness opinions, the Committee suggests that such disclosure be "to the knowledge of the member" so that no member could be held responsible for failing to disclose relationships with affiliates of its issuer/client (or with transaction counterparties and their affiliates) of which it was unaware.

COMMISSION QUESTIONS

Q.2 Whether the disclosures that would be required by proposed Rule 2290(a)(1),(2) and (3) should be quantified.

The Committee does not believe that the required disclosures need be quantified, but would not object if the rule required more disclosure if such amounts were in excess of 5% of such member's revenue, assets or market capitalization. Absent such materiality, the Committee believes a narrative disclosure of the existence of such relationships is sufficient alert to readers of the opinion.

Q.3 Whether it would be more informative to investors for firms to specifically state that a conflict may exist and describe the impact of such conflict rather than to merely state that compensation is contingent.

The Committee continues to believe that the disclosure of the existence of material relationships should be sufficient to achieve NASD's objectives and that member firms should not be required to make largely subjective and possibly pejorative judgments regarding whether any particular relationship actually constitutes a conflict of interest. We note that it has long been accepted practice that such pejorative self-assessments are not necessary in proxy statement disclosure so long as the underlying facts are appropriately disclosed.

Q.4 Whether the proposed disclosure obligation should cover material relationships between the parties to the transaction and affiliates of the member firm providing the fairness opinion.

The Committee believes it is unnecessary and generally inappropriate to expand the required disclosure to cover material relationships between the parties to the transaction and affiliates of the member firm providing the fairness opinion. Increasingly, many member firms are part of large global financial services companies that include commercial banks, private banks, insurance companies, asset management companies, commodities brokers, exchange specialists, etc. It may be extremely difficult to obtain such information from affiliates given the information barriers that exist between different business units for important legal and regulatory reasons and the disclosure of such information may also violate the privacy laws of certain jurisdictions. In addition, it would seem counterproductive to the goal of ameliorating potential conflicts of interest to require members to inform themselves about such relationships prior to rendering an opinion when those responsible for rendering the fairness opinion on behalf of the member might otherwise have been unaware that such relationships existed. Finally, as a practical matter it may well be extremely difficult for many members to establish the nature and extent of relationships that may exist between a party to a transaction and far-flung and wide ranging affiliates within the relatively compressed time frame many fairness opinions are prepared.

Q.5 Whether member firms should be required to describe what type of verification they undertook with respect to information that was supplied by the company requesting the opinion that formed a substantial basis for the opinion.

We believe that the general practice among members is to affirmatively disclose in their fairness opinions that they assume the accuracy and completeness of all information on which they rely for purposes of their analyses and opinions, including the information provided by their client that forms a substantial basis for their opinion, and do not assume any responsibility for independently verifying such information. The Committee does not object to a rule requiring such disclosure whether as a general matter or with respect to each category of information that formed a substantial basis for its opinion as contemplated by Proposed Rule 2290(a)(4).

Q.6 Whether members should be required to obtain independent verification of such information.

The Committee continues to believe that any such requirement would be both impractical and inappropriate in the context of the role fairness opinion providers play in change of control transactions. Opinion providers are generally not as deeply familiar with a company as its management, auditors and regular outside counsel. Often, they are not their client's historical financial advisor, are hired solely to advise on a particular transaction or merely to render a fairness opinion and may not even have participated in the negotiation of the underlying transaction. Companies simply do not hire opinion providers to generate or verify information, but rather to analyze it. Consequently, companies take full responsibility for the quality of the information they provide and permit opinion providers to rely on the accuracy and completeness of such information without independent verification. Furthermore, much of the most critical information (e.g., historical financial statements) is verifiable only by auditors, company management or persons other than the opinion provider or (or in the case of forward looking statements such as the projections used in discounted cash flow analyses and estimates of potential cost savings and synergies) is inherently unverifiable.

Q.7 Whether member firms should disclose the procedures utilized in the fairness opinion or elsewhere.

The Committee believes that such a requirement is unnecessary as Item 1015 of regulation M-A generally requires a summary of a fairness opinion rendered in connection with a 13e-3 transaction or referenced in a proxy statement or registration statement that includes a summary of the material financial analyses performed by the opinion provider in connection with rendering the fairness opinion.

TECHNICAL COMMENTS

1. Proposed Rule 2290(a) – covered fairness opinions

Proposed Rule 2290(a) requires any member issuing a fairness opinion that may be provided, or described, or otherwise referenced to public shareholders to disclose certain information in such fairness opinion. The Committee believes that Proposed Rule 2290(a) should be modified to apply only to:

> "*fairness opinions that are reasonably likely to be included or summarized or referred to in disclosure documents required to be filed with the Commission by issuer/clients with a class of outstanding equity securities registered under the Securities Exchange Act of 1934 and disseminated to holders of such equity securities in connection with a vote or other investment decision relating to a change of control transaction (e.g., such as those described in Rule 145 promulgated under the Securities Act of 1933, as amended, without regard to the form of consideration paid therein) that is the subject of the fairness opinion.*"

The Committee believes that there are circumstances in which a member may render a fairness opinion without a reasonable expectation that such fairness opinion will be included or summarized in a disclosure document filed with the Commission and disseminated to shareholders and that a member firm should not be in violation of the proposed rule if its reasonable expectations are defeated. In addition, we do not believe fairness opinions rendered pursuant to third party agreements (e.g., pursuant to the provisions of a loan agreement or indenture) or in connection with transactions that do not constitute a change in control need to include the additional disclosure that would otherwise be required by Proposed Rule 2290(a) merely because they may be referenced in a footnote to a financial statement or other disclosure document disseminated to shareholders. We believe that the additional suggested changes are necessary and appropriate to provide greater clarity with respect to the circumstances in which the proscribed additional disclosure is required.

2. Proposed Rule 2290(a)(1) – financial advisor

Proposed Rule 2290(a)(1) requires disclosure as to whether such member has acted as a financial advisor to any transaction that is the subject of the fairness opinion. By way of clarification, members typically act as financial advisors to entities or individuals, not transactions and, consequently, Proposed Rule 2290(a)(1) should be revised to apply when a member has acted as a financial advisor to "*a party to the transaction*" that is the subject of the fairness opinion.

3. Proposed Rule 2290(a)(3) - material relationships

Although NASD has emphasized that any required disclosure regarding material relationships need not be quantitative but need only narratively inform investors about material

relationships, the Committee believes that NASD should further clarify Proposed Rule 2290(a)(3) in order to avoid any implication that the rule requires members to breach obligations of confidentiality relating to past services performed or prematurely disclose information regarding non-public relationships understood to be contemplated. It could be enormously damaging and disruptive if a member were required to publicly disclose detailed descriptive information relating to past engagements such as abandoned attempts to divest certain subsidiaries or divisions or merge with or acquire unrelated parties as well as potential future engagements of a similar nature. It should be sufficient for members to disclose, to the extent true, that they have in the past provided, are currently providing and/or may in the future provide investment banking and other financial advice or services to the member's issuer/client and its proposed transaction counterparty for which they have been and expect to be compensated.

4. Proposed Rule 2290(a)(5) – approval/issuance of fairness opinion

Proposed Rule 2290(a)(5) requires disclosure of whether the fairness opinion was approved or issued by a fairness committee. The Committee does not believe that such information is material to a reader's evaluation of a fairness opinion, we believe such a requirement risks creating an incorrect impression that opinions approved by a "committee" were necessarily substantively better in some fashion than opinions that were not, and consequently we do not believe that such disclosure in a fairness opinion should be required by Proposed Rule 2290(a)(5). Fairness opinions are opinions of the member firm, not individual employees or groups of employees or committees and there should be no implication to the contrary. Because fairness opinions reflect the opinion of the member firm, each member firm should determine which, if any, fairness opinions must be reviewed and approved by a fairness committee as contemplated by Proposed Rule 2290(b)(1). In addition, the procedures employed by member firms vary, in some cases significantly, and some member firms may not have standing "fairness committees" but instead may authorize certain employees as members of standing or ad hoc committees to approve a variety of matters on behalf of the firm, only one of which may be the issuance of fairness opinions. If NASD and the Commission determine to require such disclosure in fairness opinions, the Committee suggests that such disclosure be revised to require disclosure as to whether the issuance of the fairness opinion was "*approved by a fairness or other committee that is authorized to review fairness opinions prior to issuance*".

5. Proposed Rule 2290(b) – procedures

Although the Release mentions requirements for written procedures in several places, nowhere in Proposed Rule 2290 does it specify that the procedures be in writing. If it is the intention of NASD that the required procedures be in writing, the Committee suggests that the word "*written*" be inserted before the word "procedures" in paragraph (b).

6. Proposed Rule 2290(b)(1)(C) – balanced review

Proposed Rule 2290(b)(1)(C) requires review and approval of fairness opinions by persons who do not serve on or advise the deal team to the transaction. While we agree that

committees reviewing the fairness opinion in a particular transaction should not be comprised of members of the deal team engaged on that transaction, fairness committees do more than approve fairness opinions. The deal team often consults the fairness committee as a transaction progresses in an effort to ensure that the deal team is using appropriate valuation techniques and otherwise providing appropriate valuation and other advice. Because some of this communication might be characterized as "advising" the deal team, the Committee suggests that the words "*or advise*" be deleted from Proposed Rule 2290(b)(1)(C).

7. Proposed Rule 2290(b)(2) – type of company or transaction

Proposed Rule 2290(b)(2) requires that a member firm's procedures state the extent to which the appropriateness of the use of valuation analyses is determined by the type of company or transaction that is the subject of the fairness opinion. As noted in the Release, fairness opinions relate to the consideration to be paid or received in transactions. Because, companies are not the subject of fairness opinions, the Committee believes Proposed Rule 2290(b)(2) should be reworded to reference whether the "*use of valuation analyses is determined by the type of transaction or companies involved in the transaction that is the subject of the fairness opinion*".

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We hope the Commission finds these views and suggestions helpful. We would be happy to meet to discuss any questions the Commission may have with respect to this letter.

Respectfully submitted,

Special Committee on Mergers, Acquisitions and
Corporate Control Contests

By: Daniel S. Sternberg, Committee Chair